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India chapter of UN's draft Practical Manual on Transfer Pricing for Developing Countries

Intent of the draft Manual and its guiding principles

The United Nations (UN) recently released eight draft chapters of its Practical Manual on Transfer Pricing for Developing Countries (the UN TP Manual or the Manual). Also included in the Manual are a foreword and a draft chapter (Chapter 10) containing country specific perspectives which explain the transfer pricing (TP) administrative practices prevalent in four countries, viz., Brazil, China, India (hereinafter referred to as India chapter), and South Africa. The UN will soon host meetings to discuss all the draft chapters.

The Manual intends to address the need of developing countries for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis. Such guidance is intended to assist policy makers and administrators in dealing with complex TP issues, and to assist taxpayers in their dealings with tax administrations.

The Manual is said to have been developed based on the following key guiding principles:

- It is a practical rather than legislative model.
- It reflects the realities for developing countries, and addresses real issues in a practical and problem-solving way.
- It is geared to the limitations in some countries' administrations, and deficits in information, skills, and resources.
- It aims to leverage upon experience of other developing countries.

Notably, the foreword in the Manual clearly states that owing to the widespread reliance on the OECD TP Guidelines[1] by both developing and developed countries, consistency with these Guidelines has been sought.

As for Chapter 10, the foreword to the Manual clarifies that this chapter is different from the other chapters as it represents an outline of the particular countries' administrative practices as described by representatives of those countries. Accordingly, as further stated in the foreword, no consensus on Chapter 10 has been sought, and thus this chapter does not reflect the official view of the UN.

The focus of this alert is the India chapter contained in Chapter 10 of the Manual.

The India chapter

The India chapter primarily discusses some of the emerging transfer pricing issues in India as described by the Indian tax administration (Indian administration). Some of the India issues have been discussed in the UN TP Manual, while others have not yet been addressed at all in the Manual. An analysis thereof is provided below.

Use of contemporaneous data

As per the India chapter contemporaneous data should be used and accordingly current year data is more relevant and appropriate so as to ensure high degree of comparability. This view is evidently in line with the approach being adopted in Indian TP audits and appellate proceedings.

On this issue, the UN TP Manual, as a general rule, suggests that contemporaneous data most likely reflects similar economic conditions and ensures a higher degree of comparability. However, the Manual recognises that as an *exception*, multiple year data may also be used when it reveals facts which could have an influence on the determination of transfer prices. This appears to be a departure from the OECD TP Guidelines as well as the Indian TP regulations, which do not seem to suggest the use of multiple year data only on *exception* basis. On the other hand, similar to OECD TP Guidelines, the UN TP Manual also states that the circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effects of life cycles for a particular product or intangible.

It may be noted that the OECD TP Guidelines say that multiple year data 'should' be used where it 'adds value' to the TP analysis. The UN TP Manual varies a bit on this aspect, as it states that multiple year data 'may' be used where it 'adds value' and 'makes the TP analysis more reliable'.

Needless to say, the onus of whether the TP analysis has become more reliable by using multiple year data or whether its use has added value would lie with the taxpayer. In the Indian context, taxpayers have historically not been able to convince Indian tax authorities in this regard. Therefore, given all of the above, Indian taxpayers cannot expect much support from the guidance provided in the UN TP Manual on the issue of use of multiple year data.

Allocation of risks

The Indian administration is of the view that risk is not an independent element, but is similar in nature to functions and assets. Further, the allocation of risk depends upon the ability of parties to the transaction to exercise control over risk.

The India chapter specifically takes an example of contract research and development (R&D) activities undertaken by Indian related parties of multi, national enterprises, and the Indian administration objects to these entities being risk free entities, entitled to (low) cost *plus* remuneration. The Indian administration challenges the ability of the foreign associated enterprise (AE) to exercise control remotely, and states that most foreign AEs are unable to submit

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010.

relevant documents to justify their claim of exercising control. The Indian administration contends that the Indian related parties undertake the core R&D activities and their monitoring, and also take strategic operational decisions and decisions relating to allocation of budget (although the funds are provided by foreign AEs), and thus control substantial part of the risks. The Indian administration hence believes that in such cases allocation of routine cost *plus* return to the Indian related parties will not be arm's length.

It is difficult to fathom such a general comment being made in respect of *inter alia* R&D structures across-the-board. An evaluation of such structures would have to be case specific and would need to be undertaken independently based on a review of the significant people functions and conduct of the parties in each case.

The UN is more pragmatic on such operational structures, which can be observed from the two examples which have been put forth in the UN TP Manual entailing performance of R&D activities. In one example, control is exercised by the subsidiary, while in the other example, control is exercised by the parent. Hereby, the UN distinguishes the entity which exercises 'control' based on ability to take strategic decisions, monitoring activities of the other entity, bearing risk of unsuccessful R&D, controlling the budget for R&D activities, etc.

Even the OECD in its recent discussion draft on intangibles, reiterated vide examples 9 to 11 of the discussion draft, that the entity which performs key people functions, controls associated risks is entitled to intangible related returns for the R&D activity.

Allocation of risk depends upon who exercises control over risk – eventually this will impact allocation of returns as well – on this point, the views of the UN and the OECD are in line with each other. However, practically speaking, the approach of the Indian administration in this regard, has so far, not been encouraging, as is evident from the example above. Although that is partly because taxpayers have been unable to fully substantiate their claims regarding control.

The answer to the question as to who exercises control is based on a factual analysis. If the Indian taxpayer has to win an argument on facts, then, needless to say, the facts must be entirely substantiated and documented. Notably, even in the examples in the UN TP Manual, significant reliance is placed on evidence put forth to substantiate claims relating to who exercises control.

Arm's length range

The India chapter reiterates that where there is more than one arm's length price (ALP), the arithmetic mean of such prices would be considered as the ALP. The India chapter further clarifies that the Indian TP regulations do not mandate use of inter-quartile range.

The OECD TP Guidelines, on the other hand, discuss the concept of 'arm's length range' and to select the most appropriate point in the range, suggest the use of different measures of central tendency (such as averages, median, etc.) depending upon the characteristics of the data set.

Interestingly, the UN TP Manual, at different places, refers to 'arm's length price or profit (or range of prices or profits)'. By this, firstly, the UN clarifies the otherwise implicit understanding that it could be arm's length 'price' or 'profit' depending upon the TP method used. Secondly, the UN seems to reflect flexibility in using the 'mean' (arm's length price or profit) or 'range' (range of prices or profits). This flexible approach is unfortunately neither reflected in the practice or views of the Indian administration, nor in the stringent provisions of the Indian TP regulations.

Comparability adjustments

Indian TP regulations provide for 'reasonably accurate comparability adjustments'. The India chapter states that it is possible to address the issues of accounting difference, difference in capacity utilisation and intensities of working capital by making comparability adjustments. But, as per the India chapter, it is extremely difficult to make risk adjustments, in absence of a reliable, robust and

internationally agreed methodology. In this regard, the India chapter also outlines detailed reasons for not using the capital asset pricing method (CAPM) for computing risk adjustments.

The UN TP Manual also acknowledges the need to make comparability adjustments where appropriate and where required such that the comparables are accurate and reliable. The discussion on comparability adjustments in the Manual essentially covers the following:

- The Manual discusses adjustments for accounting (or classification) differences, working capital adjustment, and even a functional adjustment (to account for differences in the mix of functions performed by comparables *vis-à-vis* the tested party).
- An adjustment for differences in the transactional structure is also contemplated, for example, where the tested party operates under a long-term contract, whereas comparables have short-term contracts.
- However, where comparables have significant intangibles, the Manual suggests rejection of such comparables rather than adjusting them.
- As for risk adjustment, the Manual acknowledges that similarity in the level of risk is an important consideration in selecting a comparable, and that comparability is impaired when the entities assume different economically significant risks. However, the UN accepts that there is no universally accepted method for risk adjustment, and in fact highlights a limitation of the commonly used CAPM by stating that it is based upon risk models used mainly in relation to the risk of securities. The UN cautions that a risk adjustment should be made only if a reasonable and accurate adjustment is possible.

The UN Manual contemplates several types of adjustments. However, apart from providing the formula for the working capital adjustment, there is no methodology or formula provided for any of the other types of adjustments. Accordingly, the much needed international guidance on adjustment methodology and approach is still lacking.

Location savings

The Indian administration is of the view that, location savings should be one of the major aspects while carrying out comparability analysis, and that India also provides Location Specific Advantages (LSAs) in addition to location savings, the incremental profit from which is known as 'location rent'. The main issue, as per the Indian administration, is the quantification and allocation of location savings and location rents amongst the AEs, for which it believes the profit split method can be used wherein the functional analysis and bargaining power of the parties to the transaction would be relevant factors for consideration. The Indian administration believes that by benchmarking against local comparables the benefits of location savings will not be taken into account. The benefit can be computed by taking into account, cost difference between cost of low cost country and high cost country. Further, the India chapter suggests that an arm's length compensation should reflect an appropriate split of cost savings and location rents between the parties.

On the issue of location savings, it is interesting to note that, in a recent ruling in the case of GAP International Sourcing (I) Pvt. Ltd[2] (GAP India), the views of the Indian Tribunal do not echo the views of the Indian administration in the India chapter. In the case of GAP India the Indian Tribunal held as follows:

"*...the intent of sourcing from low cost countries for a manufacturer/retailer is to survive in stiff competition by providing a lower cost to its end-customers. <u>Generally, the advantage of location savings is passed onto the end-customer via a competitive sales strategy</u>. The arm's length principle requires <u>benchmarking to be done with comparables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by comparables</u> which are used for benchmarking the international transactions. Thus in our*

[2] GAP International Sourcing (I) Pvt. Ltd *v.* ACIT [2012] 25 taxmann.com 414 (Delhi)

view, no separate / additional allocation is called for on account of location savings..." (emphasis supplied)

The UN TP Manual has also dealt with the issue of location savings in fair amount of detail. As per the UN, locations savings may be offset at times by 'dis-savings', which are higher costs incurred, for example, on account of poor infrastructure in a particular location. Thus, the 'net location savings' should be considered. Further, the UN provides the following definition for LSAs, which is different from that contemplated by the Indian administration in the India chapter: LSAs = Net location savings +/- other location benefits. LSAs lead to 'location rent', which is incremental profit derived from exploitation of LSAs.

Speaking of location rent, it is worth considering that in a state of perfect competition, which is generally speaking a market reality, location savings would not automatically lead to location rent or premium profits, as the transacting entities would be forced to pass on the benefits of the savings to the ultimate customer, in order to be competitive in pricing because their competitors would also have access to LSAs. The UN TP Manual also acknowledges this and considers competitive factors as vital in determining whether LSAs will lead to location rent. Notably, this is also in line with the view taken by the Indian Tribunal in the case of GAP India (above).

The UN TP Manual recognises that location rent could arise in the initial years (in case of a first mover advantage) or where a particular entity has exclusive access to LSAs. However, the UN rightly acknowledges that with the passage of time location rent would dissipate due to competitive pressures.

For determination of whether or not location rent exists, the UN TP Manual takes an example whereby the foreign AE has a unique production intangible which enables its local subsidiary to manufacture at lower costs than competitors as such intangibles are not available with competition. In such circumstances, the owner of the intangible, i.e., the foreign AE would have the bargaining power by virtue of it owing the intangible, and would thus be entitled to the profit from such cost savings, assuming that it has a realistic alternative to undertake production elsewhere at similarly low costs using the intangible.

A critical distinction in the above example may be worth deliberating upon – herein, the cost savings are on account of the intangible and also theoretically, on account of savings arising out of operating in a low cost jurisdiction, i.e., the location rent. If competitors have access to similar LSAs, then location rent would not exist. However, if that is not the case, and the foreign AE also has a realistic alternative of undertaking production in another low cost jurisdiction, then the location rent would be largely allocated to the foreign AE. This would be so because the realistic alternative of undertaking production in another low cost jurisdiction available to the foreign AE significantly enhances the foreign AE's bargaining power.

In the absence of any other benchmark, the relative bargaining power of the transacting parties is therefore a critical factor when determining allocation of location rent. The view is also shared by the UN in the Manual.

Intangibles

The India chapter acknowledges that transfer pricing of intangibles is difficult for the reason that comparables are difficult to find, and the intangibles are often bundled with tangible assets. The India chapter discusses several issues relating to intangibles which are often found to be the subject matter of dispute in TP audits and appellate proceedings. The intangible related issues discussed in the India chapter are briefly outlined below:

- The Indian administration finds it impossible to find *comparables for the transaction of royalty*, and for which use of profit split method also does not work as an alternative due to limited information.

- *Brand royalty* to the foreign AE will depend upon the advertising, marketing and promotion (AMP) costs incurred by the Indian entity, and thus in some cases no royalty will be payable and instead the Indian entity would need to be compensated for enhancing the brand value and creation of marketing intangible thereof. Further, the Indian entity should be compensated if a little known foreign brand is co-branded with a popular and valuable Indian brand, as the value of the foreign brand would be enhanced due to co-branding.
- As for *royalty for technical know-how*, the expenditure incurred on customisation and/or local R&D efforts to enhance the value of the know-how, would need to be considered.
- ALP determination in case of creation of marketing intangibles is based on the Bright Line concept. Indian entities which incur excessive AMP expenses bear risks and perform functions beyond what an independent distributor would incur or perform for the benefit of its own distribution activities. Therefore, Indian entities should be compensated for excessive AMP incurred by them.
- *R&D centres* in India are found to be engaged in *creation of unique intangibles*, the legal ownership of which is transferred to the foreign AE under an agreement without appropriate compensation (which should be over and above the compensation for R&D activities).

The current draft of the UN TP Manual does not contain a detailed discussion on the issue of intangibles, which is likely to be featured in the next edition of the Manual. There is, however, a brief section on intangibles in the first chapter wherein intangibles have been stated to be divided into 'trade intangibles' and 'marketing intangibles'. This is exactly how the OECD earlier dealt with intangibles. However, with OECD's recent discussion draft on intangibles, the definition of intangibles has witnessed a significant change. In that light, the brief in the UN TP Manual on intangibles seems outdated.

It may be worthwhile to note that in the context of 'Business strategies' (described in the UN TP Manual as being a relevant factor for comparability), the UN TP Manual has discussed some aspects which could be quite pertinent to the issue of marketing intangibles prevalent in India. The UN discusses market penetration, market expansion and market maintenance strategies, and recognises that this may involve substantial costs, the allocation of which, between the foreign AE and the local subsidiary, is an important issue from a TP perspective. As per the UN, the factors to be considered for the purpose of allocation of such costs would be:

- who is the initiator and the beneficiary of the strategy;
- the nature of the relationship between related parties, i.e. their responsibilities and risk profile; and
- whether there are intangibles involved, and who is their legal/ economic owner.

Quite evidently, these are important factors and should equally apply when evaluating AMP spend of Indian subsidiaries to ascertain whether or not the Indian subsidiary should at all be compensated for high AMP spend. Indian subsidiaries could certainly leverage from this guidance when arguing against any compensation. AMP spend should vest with its initiator and beneficiary. Indian taxpayers would thus need to articulate and demonstrate as to who is the initiator and the beneficiary of the AMP spend. Further, an analysis and documentation of the FAR (functions, assets and risks) profile of the Indian taxpayer *vis-à-vis* the foreign AE would be critical to ascertain and prove who undertakes the significant people functions relating to the AMP spend and who exercises control, as the AMP spend would ideally vest with that entity.

Intra-group services

When determining ALP for intra-group services, the Indian administration considers factors such as actual receipt of services, their nature and detail, their need, their benefits, and whether independent enterprise will be willing to pay for them. The Indian administration is of the view that the key challenges in determining ALP for intra-group services are ascertainment of cost base, allocation of costs (i.e., allocation keys to be used), determining whether or not a mark-up is

required (for example this could be a question in case of pass-through costs) and if yes, then the percentage of mark-up.

India believes that shareholder services, duplicate services and incidental benefits from the group do not give rise to intra-group services requiring arm's length remuneration.

Further, the Indian administration claims that most foreign AEs do not provide a mark-up on services rendered by Indian entities to them, and if they do, then the mark-up is a low varying between 5%-10%. On the other hand, in case of services provided by foreign AEs to Indian entities, the foreign AEs generally charge a high mark-up, and the services would even include shareholder services, duplicate services and incidental benefits. This generalised claim of the Indian administration is highly debatable and could be widely challenged, because the ground reality is often to the contrary. It is hoped that such sweeping comments do not influence the views of the Indian revenue authorities on such transactions.

The current draft of the UN TP Manual does not contain a detailed discussion on the issue of intra-group services. However, the Manual does put forth the following key messages:

- An intra-group service will call for an ALP determination if there is a *need* for the service, and if the recipient would be *willing to pay* for it if it was independent of the group. *Incidental benefits* without any specific services being provided should be ignored.
- If there is no direct comparable, then ALP determination can be done using *cost plus method*. Herein, the *allocation of cost* should be commensurate with the reasonably expected *benefits* to the recipient, and based on sound *accounting and commercial principles*.
- *Documentation* for intra-group services should demonstrate and focus on whether the services have *actually been provided*, the benefits from the services, and what should be the intra-group charge.

The above key messages are largely similar to those provided in the OECD TP Guidelines. They also, at least in principle, echo the factors which the Indian administration claims to consider when determining ALP of intra-group services. Accordingly, for ALP determination of intra-group services and their documentation, especially management services which is often a subject matter of dispute, it would be advisable for Indian taxpayers to be prepared upfront by following international guidance provided by OECD and the UN.

Financial transactions

The Indian administration is of the view that, in case of an outbound loan advanced by an Indian entity to its overseas AE, the Prime Lending Rate (PLR) of the Indian banks should be used instead of LIBOR or EURIBOR rate. As for outbound guarantees, Indian administration uses interest rate quotes and guarantee rate quotes available from banking companies as benchmark rates to arrive at the ALP for outbound guarantees. The difference in the credit ratings between the parent in India and the foreign AE is also taken into account.

It is further stated that the Indian administration is facing a challenge due to non-availability of specialised databases for financial transactions such as loans, guarantee fee, etc.

The current draft of the UN TP Manual does not contain any discussion on financial transactions.

Dispute resolution

The disputes resolution process has been described in the India chapter, and the introduction of legislative provisions for entering into Advance Pricing Agreements has also been briefly touched upon. Further, it is stated herein that the ability of a country to reduce the disputes by taking unilateral legislative and administrative actions is very limited at the time when cross border transactions amongst the related parties have increased substantially in the last decade. Accordingly, Indian

administration is appreciative of the guidance provided by the UN on transfer pricing.

For Indian taxpayers this is certainly encouraging as the above statements of the Indian administration clearly indicate their willingness to follow international guidance and precedents, where guidance in the Indian TP regulations is either lacking or limited.

Overall comments

There have been concerns in the past that the UN would surface with a Manual which would differ in content and concept from the prevailing international guidance primarily in the form of the OECD TP Guidelines. However, as is also evident from the above analysis, such fears are largely allayed as the UN TP Manual appears to be in line with the OECD TP Guidelines and does not deviate from the fundamentals of or the overall approach towards TP as prescribed by the OECD.

As analysed above, there are observations, on one hand, in the India chapter which are not in harmony with the principles laid out in the UN TP Manual, and there are other observations, which the current draft version of the UN TP Manual does not address. Therefore, as highlighted at the outset and just to reiterate, the India chapter does not reflect the official view of the UN. Further, although the India chapter sets out the approach and thinking of the Indian administration on various TP issues often faced in India, it would not be binding on the revenue or the judiciary. However, it could nevertheless, influence their conduct.

Given that transfer pricing is one of the most controversial tax issues in India, additional international guidance is always welcome. Since the UN TP Manual's focus is on developing countries, the guidance provided therein should be particularly relevant for taxpayers as well as revenue authorities in an emerging economy like India, not only for resolving disputes but also for improving tax administration practices.

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